CENTRE *for* ECONOMIC PERFORMANCE

ELECTION ANALYSIS

Macroeconomics and Public Finances: The worst is yet to come

- The Great Recession of 2008-9 caused a big drop in UK national output, perhaps a permanent 5% drop in GDP. The average household's wealth fell from £375,000 to £330,000 between 2007 and 2008 alone. But unemployment, currently 8%, has been low compared with previous recessions.

- From 1997 to the eve of the recession, Labour boosted public spending by 1.2% of GDP and raised taxes by 2.3% of GDP, reducing the structural deficit. But since 2007, the recession blasted a hole in the public finances and, without action, the deficit would remain unsustainably high at around 7-9% of GDP.

- Public sector net debt is currently £890 billion. Under Labour's plans to cut spending and raise taxes, this will peak at 76% of GDP in 2014, then decline to around 70% by 2018, up from a recent average of around 40%.

- The UK's long-term structural fiscal challenges notwithstanding, market prices do not indicate neither an imminent Greek-type fiscal crisis in the short run nor extreme inflation. But market appetite for gilts may decline if current debt trends continue and when short-term interest rates begin to rise.

- All the political parties are signed up to major cuts in spending and increases in taxes to reduce the deficit, but none have put forward a comprehensive plan to meet the challenge. The manifestos are broadly similar with the Conservatives planning to put a slightly greater emphasis on spending cuts.

- How soon can we start credibly reducing the deficit without risking the recovery? The Conservatives propose to cut government spending by £6 billion more than Labour's plans this year. Regardless of whether these are really 'efficiency savings', this still withdraws demand from the economy. This means spending cuts in real terms of 5.1% in all departments except health and overseas aid.

- The Conservatives would have a lower increase in National Insurance after 2011 (costing £6 billion) and the Liberal Democrats would increase personal allowances (costing £16.8 billion). These policies would further raise the deficit unless there are offsetting cuts in spending or increases in taxation.

THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Introduction

The economy seemed to have had a near death experience during the Great Recession of 2008-2009. This Election Analysis describes where we are now in terms of macroeconomic performance and the impact on the public finances. We then look at the policy options, focusing on debt reduction and economic recovery, and compare the parties' positions.

All main parties are promising huge cuts in spending and tax increases, but they are not really specifying where these will come from. The debates have focused on the narrower question of the speed with which deficit reductions will kick in, which are relatively minor. This raises the danger that the public will resist the unpleasant medicine that is coming in the next few years.

This analysis starts with where we are now, then addresses the future of public debt before analysing the policy positions of the major parties.

Where are we now?

A permanent fall in GDP?

From the early 1990s to 2007, the UK economy had a very smooth and buoyant ride: GDP grew steadily at around 3% a year, house prices grew at an average of 10% and unemployment fell from 10% to 5%. Although share prices fell sharply between 2000 and 2002, the effects on the rest of the economy were mild.

In the middle of 2007, these trends suddenly reversed. Compared with the summer of 2007, GDP has fallen by 4%, unemployment has risen to 8%, house prices have fallen by 15% and share prices have fallen by 20%.

Typically, recovery from a recession is sufficiently strong so that GDP and other variables entirely make up the lost ground and return to their earlier trajectories. There are some concerns that this may not occur in the aftermath of the 2008-10 recession. The 2010 Budget predicts a 5% permanent drop in output.

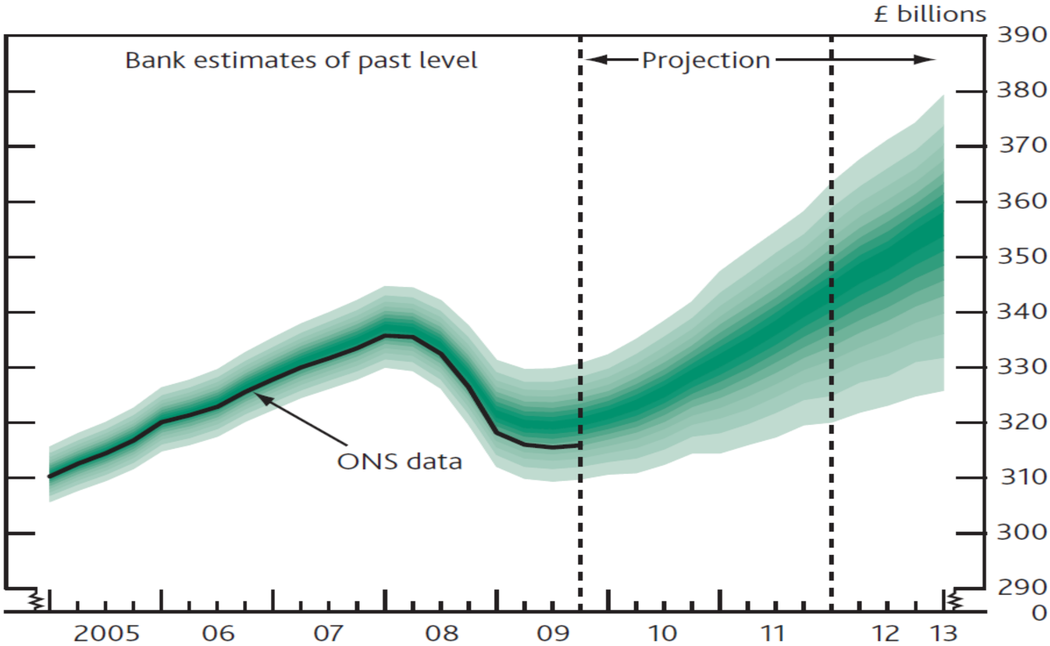
Charts showing historical and projected GDP are shaped like lightning bolts: a downward zag during 2008 and 2009, returning to an upward zig that never meets the old path (see Figure 1). Concerns about output loss are based on historical evidence that financial crises can cause permanent effects on GDP. But the magnitude is highly uncertain; for example, the OECD estimates a loss of 2-4% and the IMF a loss of 10%.

Unemployment up, but by less than expected

Figure 2 shows unemployment rates and GDP growth since 1974 (recessions in grey). Although the latest figures show we appear to be out of recession, the cumulative fall in output during the most recent recession has been greater than in the 1980s and 1990s. But unemployment has risen by less and still stands well below the peaks of the 1980s and 1990s. Part of this may be due to an improvement in the functioning of the labour market with a more effective Employment Service and programmes like the New Deal.[1]

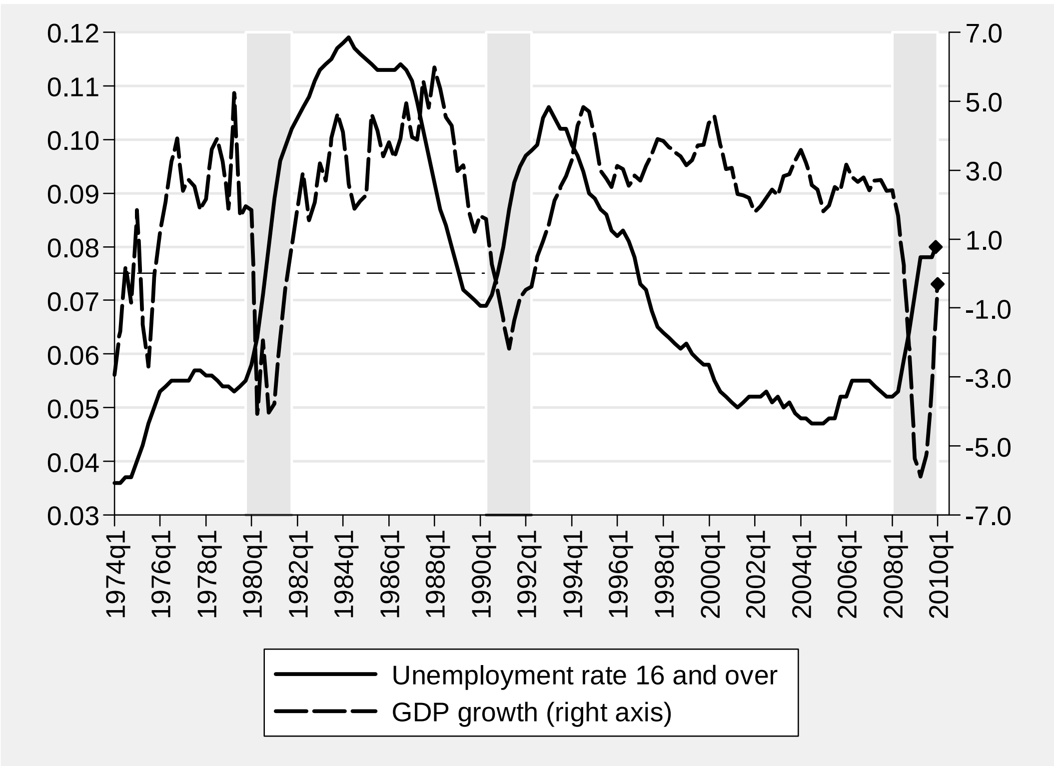
[1] See CEP Election Analysis on jobs and youth unemployment (http://cep.lse.ac.uk/_new/news/year.asp?yyyy=2010#2015)

Figure 1: GDP, historical and projections by the Bank of England



Source: Bank of England *Inflation Report*, February 2010

Figure 2: UK unemployment and annual GDP growth rate, 1974-2010



Source: ILO quarterly unemployment rate for 16 and over from 1974q1 to 2010q1 – the last point is the rolling average for 12/2009-02/2010. ONS GDP from 1974q1 to 2010q1: annual GDP growth – the last point is the GDP preliminary estimate for the first quarter 2010.

Assets down, savings up

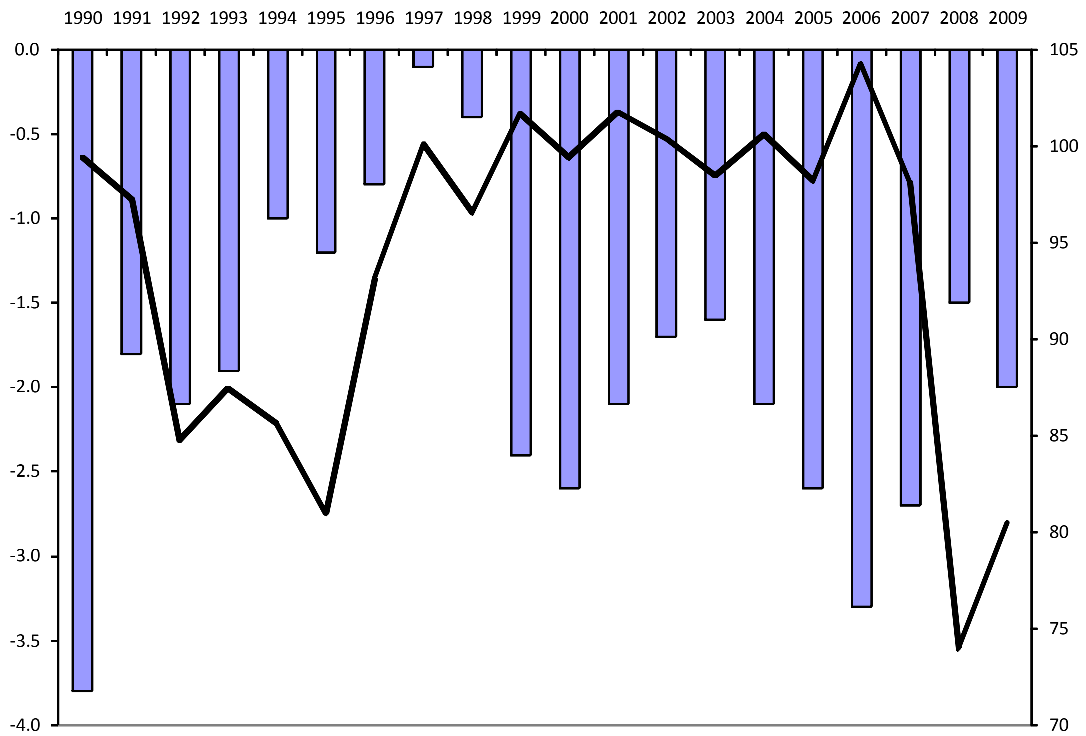
The recession hit the UK harder than some other countries because asset prices (house prices and shares) were overvalued, household debt was particularly high and the financial sector is very large – employing one in five of the workforce and responsible for more than half of the jobs increase since 1995.

The UK's private savings ratio (the proportion of private disposable income that is not spent) fell from 12% in the early 1990s to zero in 2008, but jumped to 9% in 2009.[2] An important reason for the decline in savings rates was the growth in house prices. Household net worth fell from £7.5 trillion to £6.6 trillion between 2007 and 2008, which is a fall from £375,000 to £330,000 – more than a year's income.

External imbalances and sterling

With low savings rates and stable investment of around 15% of GDP, the boom was accompanied and funded by a current account deficit. For the past 20 years, the UK ran trade deficits most years ranging around 3% of GDP in recent years (see Figure 3). Historical experience shows that deep recessions caused by financial crises tend to end with export booms.[3] While sterling significantly weakened during the crisis and the current account deficit initially narrowed to 1.5% of GDP in 2008, it then widened to 2% in 2009 and the trade deficit has widened further in the first few months of 2010.

Figure 3: Current account deficit as a percentage of GDP (bars, left-hand scale) and Effective Exchange Rate Index (line, right-hand scale)



Source: Bank of England and IMF *World Economic Outlook*

[2] http://www.statistics.gov.uk/STATBASE/tsdataset.asp?vlnk=221&More=N&All=Y
[3] IMF *World Economic Outlook* (WEO), April 2009

Public finances: deficits and debt

From 1997 to 2007, the public deficit was reduced by Labour by about 1.1 percentage points of GDP. Government spending increased dramatically after 2000, raising the share of public spending in GDP to 41.1%, an increase of 1.2 percentage points. These have improved outcomes in health, education and crime.[4] But Labour also increased tax revenues by 2.3 percentage points to 38.7% of GDP.[5]

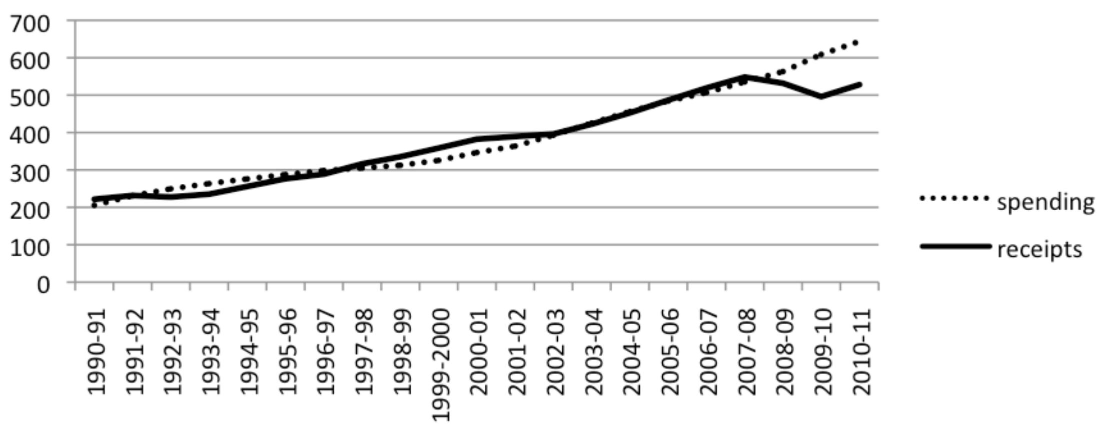
Since 2007, tax revenues have followed the zigzag pattern of GDP but government spending has continued along a rising path. This has opened up a gap between expenditure and revenue equalling around 10% of GDP (see Figure 4).

In thinking about the current fiscal deficit, three factors are important:

First, during recessions, tax revenues decline and government expenditures rise due to 'automatic stabilisers'. Unemployment benefits and other forms of social spending tend to increase while revenues decline more than proportionally due to the progressivity of the tax code. *This automatically re-adjusts as the economy recovers.*

Second, governments may increase expenditures and reduce tax rates through temporary discretionary policies, aimed at counteracting the recession or limiting its social costs. This also reflects a temporary component of the deficit insofar as the discretionary measures undertaken are truly temporary. The reduction in the VAT rate has already been reversed. The deferral of business taxes has not only been reversed, but will contribute to added revenues in 2010-12. On the other hand, the discretionary increases in expenditures involved across-the-board increases in public expenditures that may be more difficult politically to reverse.

Figure 4: Budget spending and receipts



Source: HM Treasury. Current spending and public sector total receipts, in £ billion

Third, a permanent decline in output causes a permanent decrease in tax receipts, requiring a commensurate decrease in expenditures, if long-term budget balance is to be achieved.

[4] See CEP Election Analyses in each area (http://cep.lse.ac.uk/_new/publications/series.asp?prog=CEPEA)
[5] HM Treasury, *Public Finances Databank*, March 2010

This has the most significant long-term impact, as it implies a permanent increase in the deficit. Estimates of the 2009-10 structural deficit range from 7.8% to 9%, second only to Ireland among advanced economies.[6]

On the other hand, public sector wages have historically matched the trends of private sector wages and are therefore likely to decline in upcoming years. Thus the structural deficit may overstate the actual fiscal difficulties that the UK will face.

The main consequence of high deficits is an increase in public indebtedness. The recent sequence of large government deficits has been funded by borrowing from financial markets, thereby increasing total government debt. During its first decade in power, the Labour government kept net public debt below 40% of GDP, but it is now projected to increase to 76% of GDP by 2014 (see Figure 5). Only around one tenth of that increase is due to financial sector interventions; most is due to the permanent fall in tax revenue while government expenditure has continued to rise.

There has been considerable argument over whether the UK will suffer because of its large debt and how urgently the government should attempt to close the deficit. The answer turns largely on how financial markets perceive the future credibility of the UK in repaying this debt.

In 2009, the UK had the second highest budget deficit among the members of the G7 (11% of GDP; the United States was first with 12%). In contrast, net debt has remained relatively low (44% of GDP in 2009) and even in 2014, when UK debt is projected to hit 76%, it will have much less debt than Italy or Japan (at 125% and 143% respectively).[7]

Perhaps because of this, at present markets seem to be fairly sanguine: the government is currently able to borrow for 10 years at 4%, a low interest rate by historical standards and a rate no different from what has been available to the government since the mid-1990s. Spreads between interest rates on UK bonds relative to US or German bonds are insignificant.[8]

Short-term interest rates are significantly lower than they have been at any time in recent history due to the effectively zero short-term interest rate set by the Bank of England. Inflation expectations have also been low during the crisis, implying limited market concern that the real size of government debt will be reduced through the use of inflation. But inflation expectations have risen and currently stand at close to 3.5%.

There is some economic evidence that deficits affect yields on government debt even after controlling for the total stock of debt,[9] as deficits tend to be persistent and politically difficult to unwind. The IMF estimates that the UK government will need to run structural budget surpluses of 5% throughout the 2020s to bring the public debt stock down to 60% of GDP. This would require a 12.8 percentage point adjustment in the structural deficit as a proportion of GDP in the upcoming decade – one of the largest fiscal adjustments in recent history.[10]

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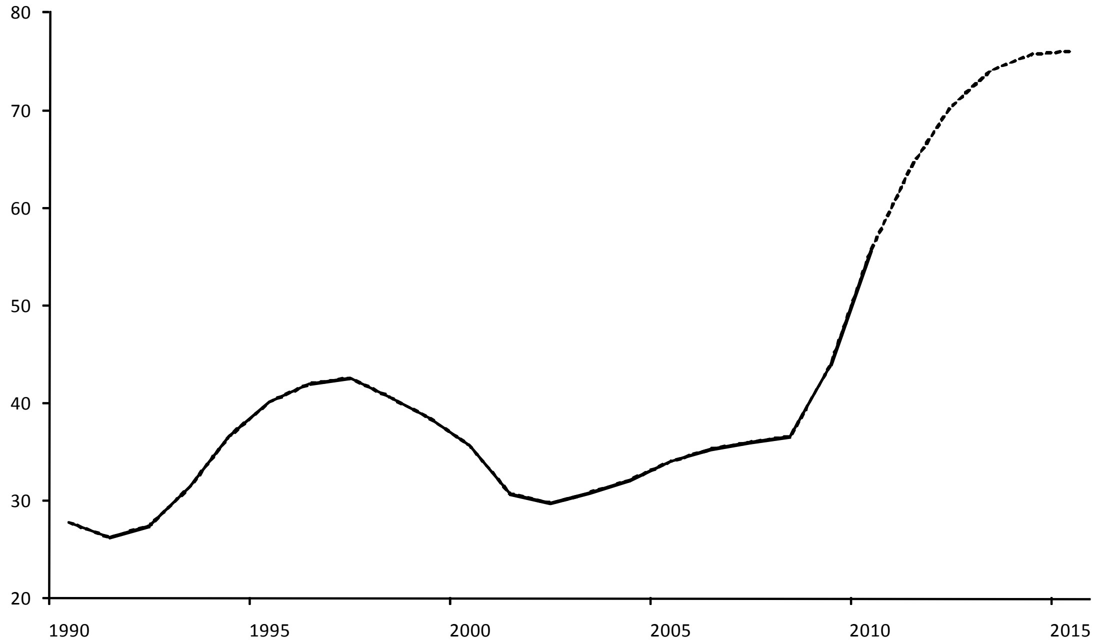
[6] Estimates from IMF (2009), and the 2009 Pre-Budget Report
[7] Data from the IMF's WEO, October 2009
[8] See Figure 6 in IMF (2009)
[9] IMF (2009)
[10] Table 9 in IMF (2009)

Figure 5: Net public debt, historical and projections (percentage of GDP)



Source: HM Treasury *Public Finance Database*

Another potential required adjustment is in the maturity of public debt. The maturity of outstanding debt has shortened with short-maturity gilts now comprising close to 20% of gross public debt, compared with 15% in the recent past. This may reflect the Treasury's desire to take advantage of low short-term interest rates. But modest increases in interest rates could significantly increase the cost of maintaining this level of debt.

Policy options and party proposals

The medium term: To the end of the next parliament and beyond

In the 2009 and 2010 Budgets, Labour announced long-term plans to resolve the deficit by (a) halving capital expenditure between 2009 and 2012; (b) reducing general departmental funding by 2% a year from April 2011 (compared with historical growth of around 4%); and (c) from April 2011, introducing a 50% income tax bracket on earnings exceeding £150,000 and restricting tax allowances for those over £100,000. Labour also announced a public wage freeze for high-income public employees.

The Conservatives have proposed[11] (a) a one-year public pay freeze in 2011; (b) bringing forward the date at which the state pension age starts to rise to 66 to no earlier than 2016 for men and 2020 for women; (c) stopping tax credits to families with incomes over £50,000; (d) cutting spending on Child Trust Funds for all but the poorest third of families and families with disabled children; and (e) balancing the structural current budget by the end of the forecasting horizon (2015-16).

A more detailed analysis of the parties' specific proposals and other deficit reduction options is in Table 1. There is substantial overlap in the macroeconomic policies of all parties: all are

[11] http://media.conservatives.s3.amazonaws.com/manifesto/cpmanifesto2010_hires.pdf, p.8

proposing stringent cuts to the deficit. The government is proposing to stablise the debt to GDP ratio in 2016/17 whereas the Conservatives say they will do it a year earlier by 2015/16. The government is proposing to split the deficit reduction one third in tax rises and two thirds in spending cuts, whereas the Conservatives would do one fifth in taxes and four fifths in spending cuts.

These plans are not specific enough to be credible. The Liberal Democrats have identified more concrete savings (such as not replacing Trident) but even these amount to only £6.5 billion. They have also pledged to increase personal allowances to £10,000, which would give away £16.8 billion in 2011/12. This would be paid for by various other tax measures, such as 'anti-avoidance' measures, which realists would argue are highly unlikely to work.

The short run: what happens over the next year?
Even though most pain has been deferred until after the election, the government has started to tighten the fiscal belt this year, for example, by increasing taxes on those over £100,000, withdrawing the VAT reduction and reducing capital expenditure. Some economists have voiced concerns that the required adjustment in the structural deficit is so large that some immediate measures must be taken to lower the deficit. Others worry that starting the cuts too soon (say in 2010/11) could push the UK back into a recession.[12]

The Conservatives have been arguing for swifter action to reduce the deficit, but the concrete measures proposed amount to a reduction of only £6 billion in spending in 2010/11 compared with Labour. On top of this, they propose to restrict the planned increases in employer's National Insurance from 2011, which will lead to lower tax revenues of £6 billion. The magic circle is squared through pointing to an additional £12 billion of 'efficiency' savings. The government itself has pencilled in £11 billion of these for 2011, but we should be sceptical – efficiencies are elusive and hard to achieve.

In any case, a reduction of spending remains just that, whether achieved 'painlessly' through efficiency gains or more painfully from a fall in the quality of public services. It will reduce demand and endanger the recovery if it really is so fragile.

Conclusions

There are initial signs of recovery from the deep recession of 2008 to 2009. But the recovery may be slow and there is still no sign of a significant reversal in the current account deficits that the UK has run for the past two decades. These problems may be compounded by large deficits and the medium-term challenge of public debt reduction.

All parties have been vociferous in their rhetoric on public debt reduction. Deficit and debt reduction will be painful, with the agony unequally distributed across the electorate. The parties have articulated specific targets and piecemeal measures to address the public debt challenge, but no party has put forward a comprehensive plan to address the structural deficit challenges that are likely to be central to the economic policy agenda of the elected government.

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[12] For example, see the exchange of letters between 80 economists in the *Sunday Times* (13 February 2010) and the *Financial Times* (19 February 2010).

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Table 1: Dealing with the deficit?

Policy	Party proposals	Potential impact
INCREASING TAXES		
Increasing taxes on high-income earnings	From April 2010, there is a new 50% income tax bracket, restricted tax allowances on pension contributions for people earning above £150,000 and withdrawal of personal allowances for those earning above £100,000. The other parties will keep these measures in place.	The 50% income tax bracket is projected to yield revenues of approximately 0.1% of GDP and thus will not bring a significant long-run decrease in the deficit.[13]
National Insurance	From April 2011, Labour will increase employer and employee National Insurance (NI) by 1p. This is combined with an increase in the point at which lower earners pay NI to £1,170, meaning that low earners will pay less NI. The Conservatives will restrict the increase in NI so there will be less NI levied on workers earning under £45,400.	Labour plans will raise about £6.3 billion, just about all of which will be lost under Conservative plans. Employers' NI will translate through to lower wages.
Personal allowances	The Liberal Democrats will raise the income tax personal allowance to £10,000	This would cost about £16.8 billion in 2011/12
Increasing the VAT rate or broadening the VAT base	While VAT is a popular tax among economists, due to its relatively non-distortionary nature, neither party has proposed an increase in VAT.	The VAT rate of 17.5% is below the European level of 19.5%, indicating that tax increases on this front are feasible. A 3.5% increase in the VAT would raise around 1% of GDP in tax revenues.[14] Broadening the VAT base and eliminating exemptions could increase revenues by up to 3% of GDP a year.

[13] 2009 Budget
[14] IFS (2010)

Policy	Party proposals	Potential impact
Cutting tax credits	The Conservatives have proposed stopping tax credits for households earning in excess of £50,000.	This is a relatively progressive way to increase tax revenues. But it is likely to yield less than £100 million of new revenues.[15]
Bank taxes	The Liberal Democrats will put an additional 10% tax on UK banks (raising £2.2 billion), the Conservatives a £1 billion levy. Labour wants an international deal on a financial transactions tax.	Bank taxes levied solely in the UK (as the opposition parties propose) could lead to banks relocating away from the UK. Crude bank taxes by themselves will do little to deal with the problem of financial regulation that caused the crisis – see CEP Election Analysis on Financial Regulation (http://cep.lse.ac.uk/pubs/download/ea011.pdf).
Other taxes	The Liberal Democrats will (i) reform air passenger duty and introduce taxes for domestic flights (£3.3 billion); (ii) introduce 1% tax on domestic property values over £2 million ('mansion tax') – £1.7 billion; (iii) reduce capital gains allowances (£1.9 billion).	
CUTTING GOVERNMENT EXPENDITURES		
Public sector wages	Labour and the Conservatives have proposed public sector pay freezes. The Conservatives have also proposed capping public sector pensions for public employees with earnings in excess of £50,000. The Liberal Democrats have proposed a £400 pay raise cap for all public employees.	When public expenditures cuts are necessary during recessions, public wage freezes or cuts are particularly attractive options. They help cut government expenditure in real terms but have more limited macroeconomic and social costs relative to cutting public good provision or public investment. They may lower the fiscal deficit with a limited reduction in the provision of public goods; at the same time, they do not add workers to the unemployment pool and public workers are less likely to leave public service for private sector jobs. The long-run fiscal benefit of such cuts depends on whether they cause a permanent decline in public wages. Labour's wage freeze is projected to reduce expenditures cumulatively by 0.2% of GDP, which has a negligible effect on long-run debt and will only have a small and temporary impact on the budget deficit.
Slowing the growth of public expenditures	Labour has proposed cutting departmental funding by 2% a year in real terms in 2011 to 2014 and halving public investments. The Conservatives have proposed cutting spending on Child Trust Funds for all but the poorest third of families and families with disabled children. Liberal Democrats have proposed to end government payments into Child Trust Funds.	Labour's proposal could have a significant impact on public debt, but lacks specifics in how such radical cuts will be achieved. Drastic cuts in public investments could have an impact on economic growth in the medium term.

[15] Author's estimate: the Treasury estimates that approximately 153,500 with incomes above £50,000 receive the Child Tax Credit, some of whom would still receive under the Conservatives' plan. They receive less than the standard rate of £545, putting an upper bound of £82 million on savings due to this proposal.

Policy	Party proposals	Potential impact
Structural policies		
Increasing the retirement age	The Turner review, overseen by the Blair government in 2004, proposes increasing women's retirement age to 65 by 2020 and raise both sexes' retirement age to 66 in 2026.[16] The Conservatives have proposed bringing forward the date at which the state pension age starts to rise to 66, to no earlier than 2016 for men and 2020 for women.	It is estimated that increasing the full pension age to 68 for men and women by 2030 would give (cumulative) savings of 0.6% of GDP. As this reform is more ambitious than proposed by either party, it gives an upper bound to the potential revenues that are available through pension reform.
BUDGETARY INSTITUTIONS		
Fiscal rules versus fiscal committees	Both parties have considered institutional arrangements that might help control deficits in the future and serve as a check on the Treasury in the budgetary process. Labour's approach has been 'rule-based' in that it attempts to limit future deficits through a form of fiscal rule. In February, Labour passed a Fiscal Stability Act, which updated the draft Code for Fiscal Stability.[17] The Conservatives have instead proposed an institutional arrangement in the form of a Budgetary Responsibility Committee, which would produce medium-term budget forecasts and assess the long-term sustainability of the public finances.[18]	There is limited economic research on the relative advantages of rules and committees in the fiscal process. IMF research has shown that fiscal rules have been helpful in fiscal consolidation, but do not compare rules to the alternative proposal.[19] The common argument in favour of a fiscal council is that it allows some discretion (based ideally on professional expertise rather than political considerations) in reacting to new conditions. Another argument is that it is very common for fiscal rules to be violated.[20] Proponents of institutional arrangements argue that the force of the moral suasion of a fiscal council exceeds the quasi-legal force of a fiscal rule. Proponents of a fiscal rule argue that it provides a clear target and that an institution like a fiscal council is likely to be subject to political pressure. In practical terms, the devil is likely to be in the details. The effectiveness of a fiscal committee depends on its institutional structure, authority, and degree of independence. The effectiveness of a fiscal rule depends on enforcement mechanisms.

[16] http://www.guardian.co.uk/politics/2009/oct/06/retirement-age-david-cameron
[17] http://www.hm-treasury.gov.uk/d/fiscal_stability_draft_code.pdf
[18] http://www.ft.com/cms/s/0/8b4fa40e-fa4c-11de-beed-00144feab49a,s01=1.html
[19] IMF (2009)
[20] Think of the case of Greece: officially it was bound by the eurozone's Stability and Growth Pact, which limits deficits to 3% of GDP, but in practice Greece ran deficits in excess of 9% and has violated the terms of the pact every year